9th OECD-ADBI Roundtable on Capital Market Reform in Asia

26-27 February 2008, ADBI, Tokyo

Session 2:
Enhancing the Regulatory Framework

Mutual Recognition and Harmonization of Standards in Asia : An Overview

by
Andrew Sheng

Outline

① Where are Asian capital markets today?
② Are Asian capital markets ready for globalization and regional integration?
③ What are the regulatory issues and challenges of capital market reform?
④ Mutual recognition and harmonization of regulatory standards for market integration
- Difference between harmonization and mutual recognition
- Rationale for mutual recognition and convergence
- The rules and laws to converge

⑤ The institutional development issues
⑥ Concluding remarks

Where are Asian Capital Markets Today?

Asian capital markets have recovered from 1997-98 Asian Crisis, raising greater funds with wider range of financial products and services

Progress on the regulatory front in various jurisdictions to apply international standards to capital market practices (financial reporting, trading, clearing and settlement processes)

National Capital Market Master Plans have been widely adopted to set the pace for capital market reform, including the streamlining of regulatory infrastructure to facilitate greater efficiency of surveillance and enforcement and promote capital market competitiveness and market innovation

Regional Initiatives on Capital Market Reform in Asia

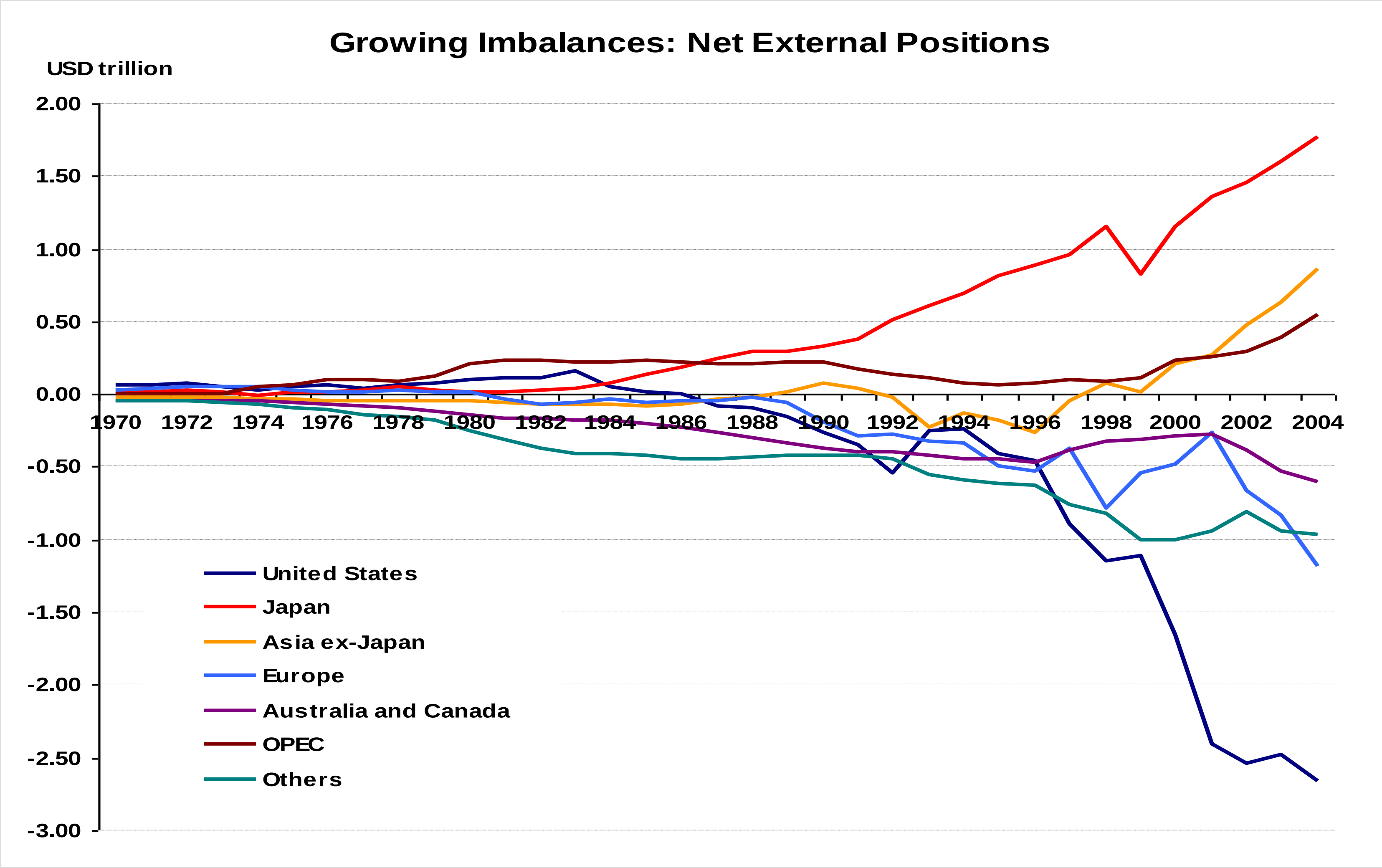
ASEAN Finance Ministers	► 2003 ASEAN Roadmap for Financial and Monetary Integration ► 2005 Agreement to develop an interlinked ASEAN securities market by 2010 ► 2005 FTSE/ASEAN Index Series to standardize market indices in the region
ASEAN+3 (China, Japan, Korea)	► 2000 Chiang Mai Initiative: regional mechanism for a multilateral ASEAN Swap Arrangement and a series of Bilateral Swaps to address short-term regional liquidity difficulties ► 2003 Asian Bond Market Initiative (ABMI) to promote the issuance and trading of bonds within region ► 2004 Asian Bond Online Website
Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)	► Asian Bond Fund… (ABF1 launched in 2003 and ABF2 in 2005)
Asia-Pacific Economic Co-operation (APEC)	► Finance Ministers' Process… focusing on a range of policy and capacity building initiatives, including financial reform

East Asia
Financial and Capital Markets

- The success in East Asian exports and high savings created a high level of net foreign asset position due to current account surplus, plus from high inflow of FDI, and FPI
- This success created two distinct phenomena:
  - Excess reserves buildup creating "Asia as the Net Exporter of Capital" and causing global imbalance *(Lane and Milesi-Ferretti, 2006)*
  - Recycled savings return to Asia, creating the "Total Equity Return Swap" effect *(Dooley, Folkerts-Landau and Garber, 2003)*

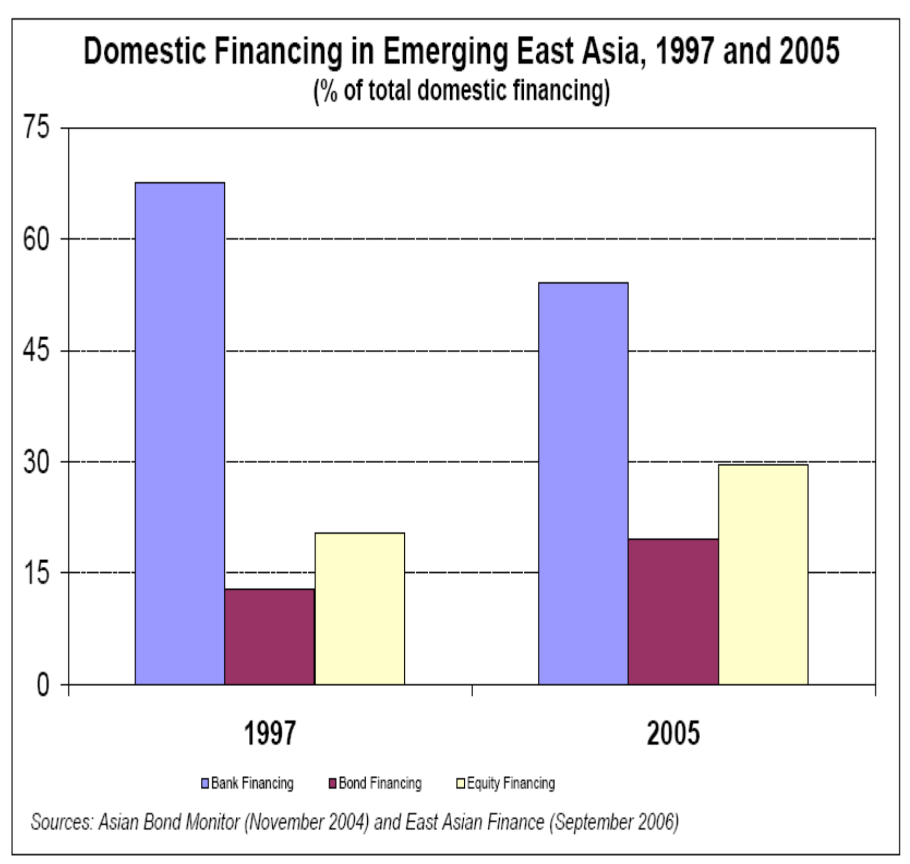
- East Asia's sterling growth in exports brought in high accumulation of foreign reserves, and created a situation where East Asia is both an exporter of manufactures and services and capital *(Lane and Milesi-Ferretti, 2006)*
- At end 2004, Asia had a net asset position of 30% of GDP (US$2.7 trillion), whereas Europe had a net liability of 9.3% of GDP (US$1.2 trillion), and NAFTA had a much larger net liability of 22.9% of GDP (US$3.1 trillion)

Asia is now Net Creditor to US and Europe (US$ Trillion)



Source: Lane and Milesi-Ferretti (2006)

Domestic Financing in East Asia is Bank-Dominated



Despite the lessons of the Asian crisis and efforts to develop bond and equity markets, the Asian financial system remains bank-dominated, with still fledgling bond markets, speculative stock markets, and relatively small insurance and pension and social security systems.

Equity, Bond, Insurance + Pension Markets Remain Relatively Under-Developed

	Bank Assets[a]		Equity Market[b]		Bond Market[c]		Insurance Market[d]	
	1990	2006	1990	2006	1990	2005	1990	2005
ASEAN								
Brunei	-	60.4[5]	-	-	-	-	-	-
Cambodia	3.2[3]	8.5	-	-	-	-	-	-
Indonesia	41.9	32.9	4.5	30.4	0.1[1]	20.3	0.9	1.5
Lao PDR	5.5	8.4	-	-	-	-	-	-
Malaysia	103.0	117.4	100.7	141.0	69.9	90.5	3.0	5.6
Myanmar	4.8[1]	6.1[5]	-	-	-	-	-	-
Philippines	23.4	40.3	20.6	46.7	25.8	38.9	2.0	1.5
Singapore	89.0	114.8	95.9	290.8	27.7	57.8	3.0	8.8
Thailand	84.6	99.0	29.2	64.3	9.8	41.3	1.7	3.6
Vietnam	9.0[4]	63.0[5]	-	-	-	-	0.4[3]	1.6
ASIA - OTHERS								
China	100.3	165.1	2.4[2]	60.4	5.9	34.1	0.8	2.7
Hong Kong SAR	145.6[1]	156.1	105.2	903.6	1.5	27.7	3.0[2]	9.9
India	32.2	57.6	10.4	76.2	19.8	33.0	1.5	3.2
Japan	226.8	154.7	122.6	109.8	86.4	191.5	8.5	10.6
Korea, Rep. of	50.7	101.6	48.2	88.2	44.3	102.0	11.0	10.5
Taiwan	-	236.4	104.6	163.21	16.6	55.9	-	14.2
LATIN AMERICA								
Brazil	35.2[2]	72.4	6.7	55.9	2.2[2]	58.8	1.4	3.0
Chile	45.1	62.9	36.8	107.5	27.6	37.1	2.7	3.9
Mexico	27.6	30.0	10.5	35.3	20.7	32.1	1.1	1.7
OTHERS								
South Africa	54.0	77.3	120.7	253.1	103.4	45.6	9.6	13.8
SELECTED OECD ECONOMIES								
Switzerland	165.4	179.8	70.7	312.5	57.7	64.4	7.8	11.2
United Kingdom	113.7	164.4	85.2	158.2	36.8	46.8	9.6	13.7
United States	62.3	62.8	57.5	146.2	121.7	160.8	8.3	9.2

Sources: World Bank Financial Structure Dataset, August 2007, IMF, World Federation of Exchanges, Central Bank of the Republic of China (Taiwan)

a. Deposit Money Bank Assets as % of GDP

b. Stock Market Capitalization as % of GDP

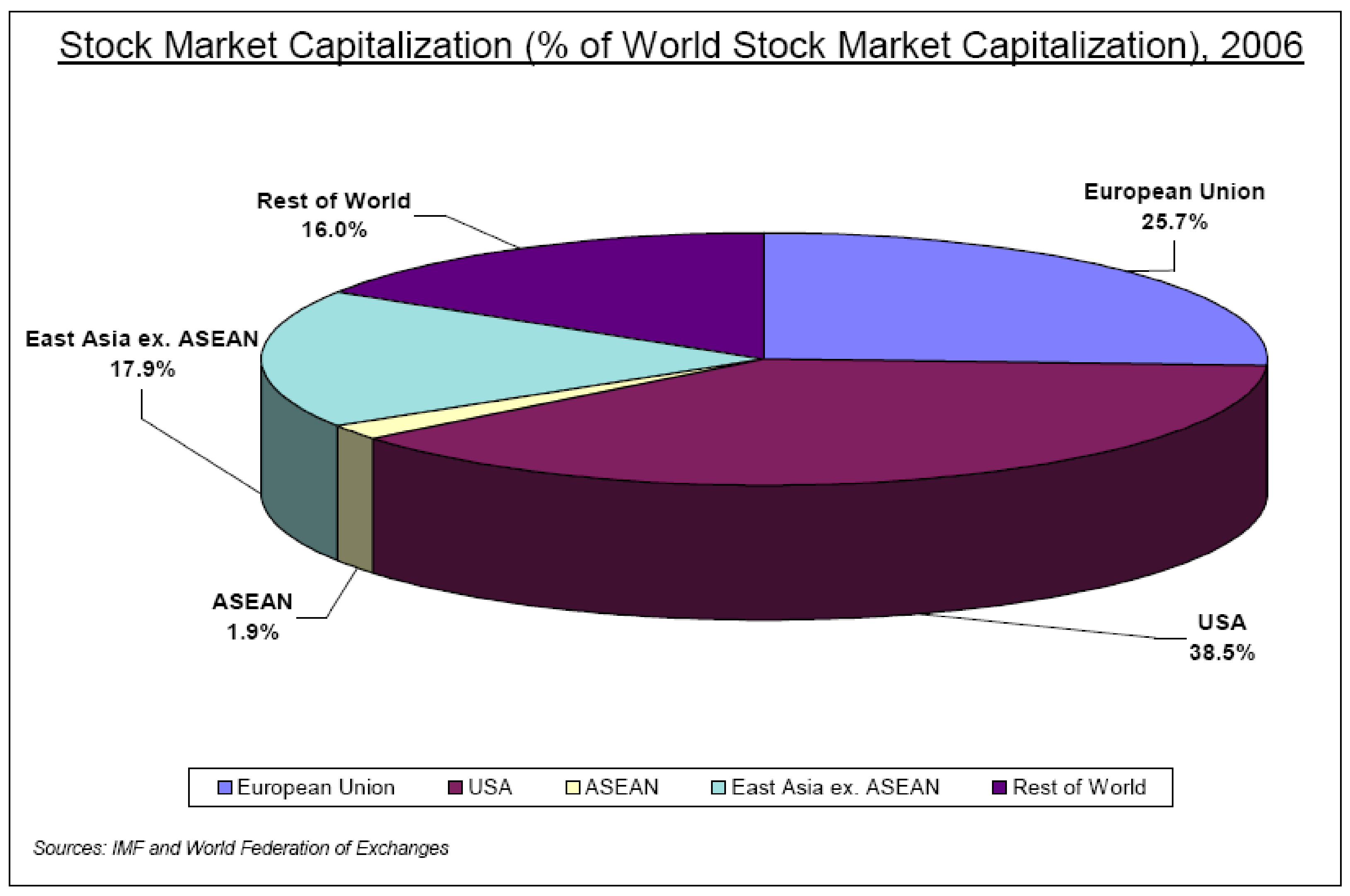
c. Public and Private Bond Market Capitalization as % of GDP

d. Life and Non-Life Insurance Premium Volume as % of GDP

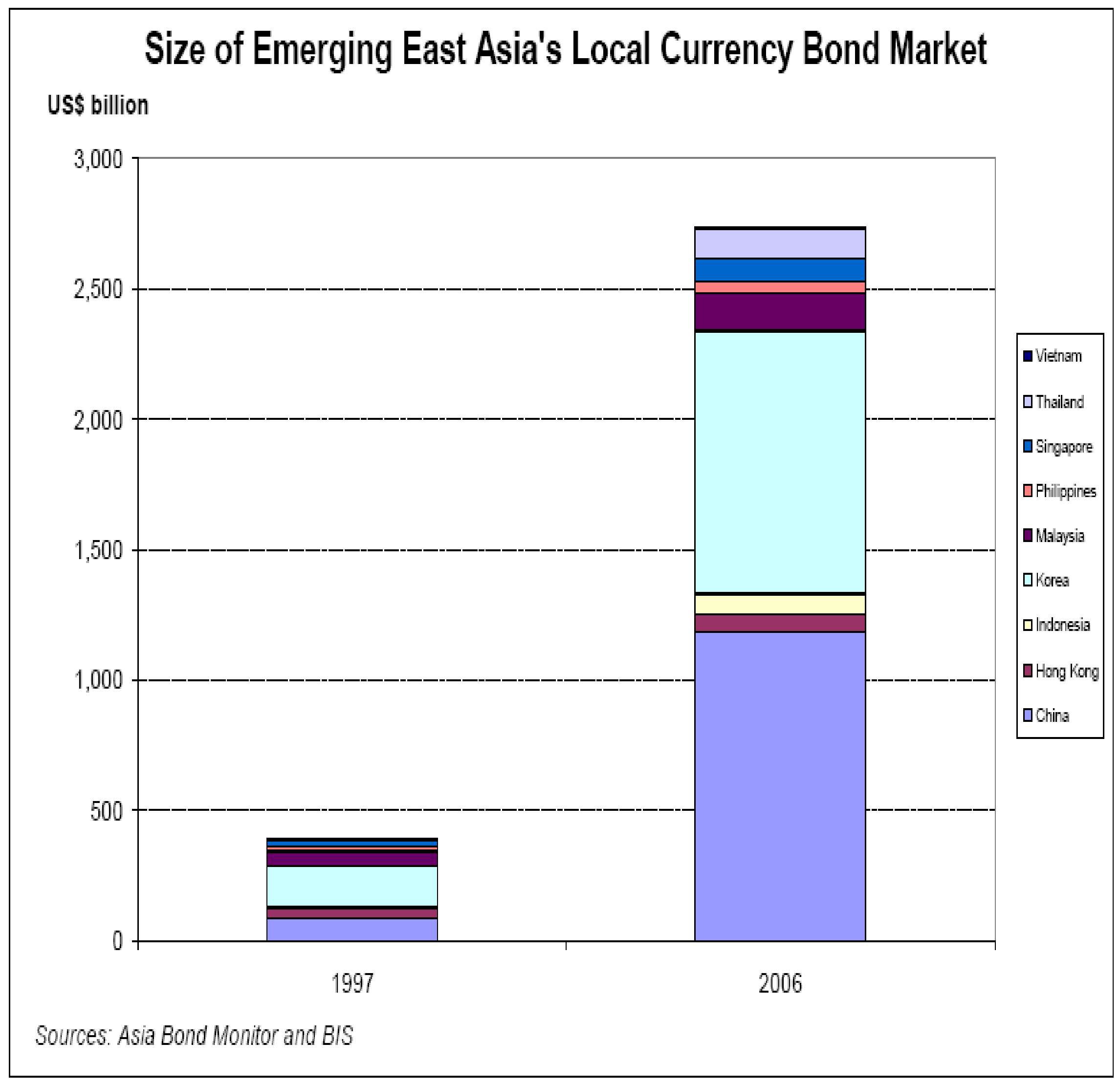
1. 1991 data; 2. 1992 data; 3. 1995 data; 4. 2005 data

- means data not available

East Asian Capital Market Remains Small



East Asian Debt Markets Still Relatively Shallow and Lack Integration



In terms of debt markets:

- ► The scale of regional bond market expanded more than 6.9 times in US dollar terms between 1997 and 2006
- ► In terms of its ratio to GDP, it rose from 16.7% to 57.5% during these nine years
- ► However, the U.S. dollar and the Euro still dominate the international bond markets
- ► Together, they amount to around 90% of total issues in the first quarter of 2005

Are Asian Markets Ready for Globalization and Regional Integration?

- Individually, the more advanced markets in Asia are ready to liberalize and meet the challenges of international competition and globalization
- The less advanced markets prefer a gradualistic approach
- Based on 2007 ADB study on regional co-operation among ASEAN equity markets, only two of the ASEAN-5 exchanges are actively seeking cross-border strategic alliances in order to keep up with this global trend

Asian Crisis (97-98) vs Subprime (07-08?)

- Excessive liquidity
- Large capital flows
- Asset bubbles
- Excessive leverage in corporations
- Financial Liberalization
- Lack of transparency
- Inadequate Supervision
- Moral Hazard – close banks
- Policy response – raise interest rates
- Cut fiscal expenditure

- Yes
- Yen-carry+
- Yes
- Yes, in household sector
- CDO and RMBS
- Lack of understanding of complex instruments
- Regulators caught off-guard
- Greenspan Put and Blanket Deposit Guarantee – rescue Northern Rock
- Lower Interest rates
- Increase fiscal stimulus

Global Financial System changing with new players, products and dynamic trading behaviour: US$ trillion

	2000	2006E	CAGR 2000-06E
Pension Funds	16.1	21.6	5
Mutual Funds	11.9	19.3	8
Insurance Funds	10.1	18.5	11
Petrodollar assets	1.2-1.4	3.4-3.8	19
Asian central bank FX reserves	1.1	3.1	20
Hedge Funds	0.5	1.4	19
Private Equity	0.3	0.7	14

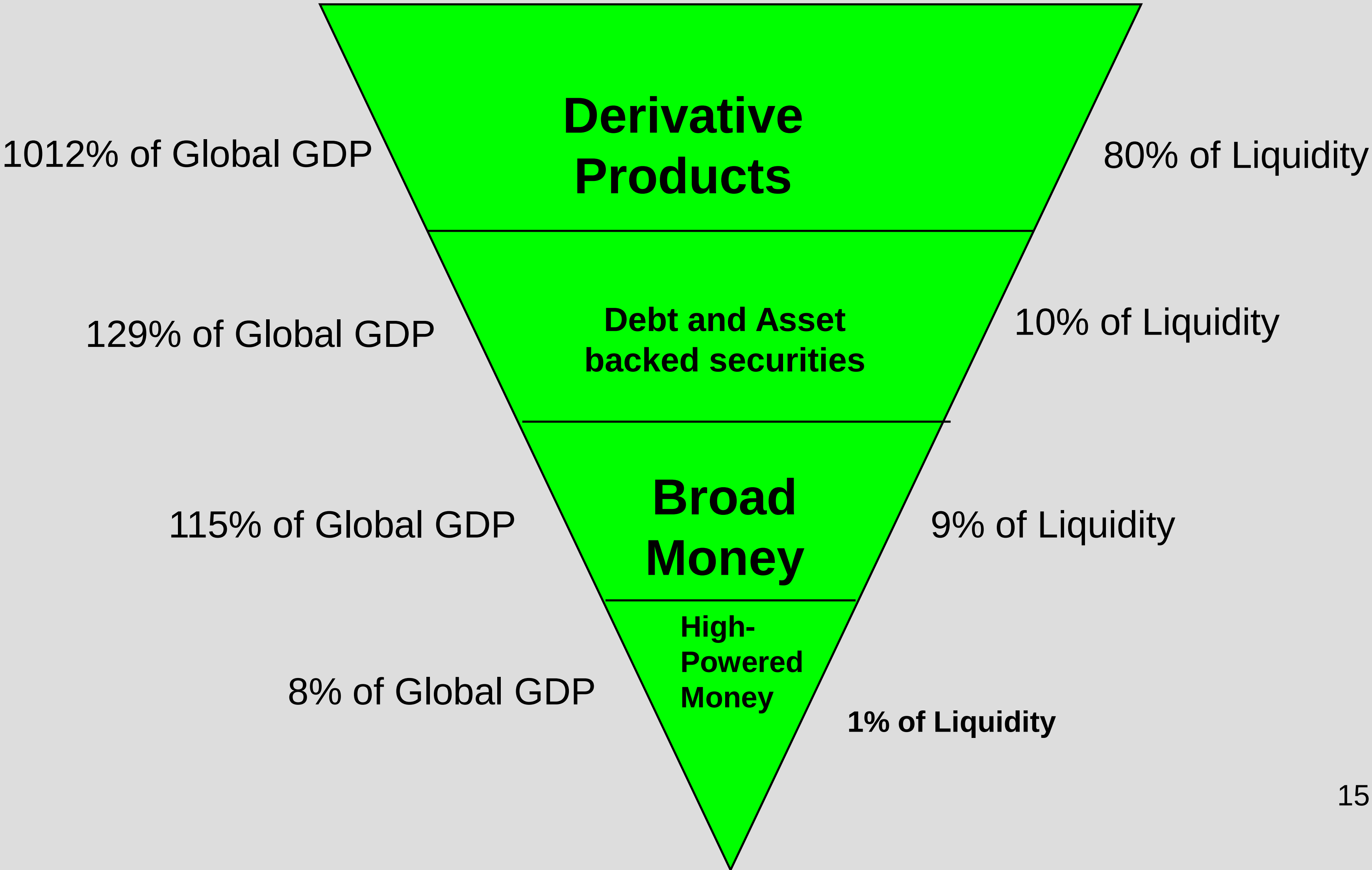
Source: MGI, McKinsey Global Institute Analysis

Global Leverage (exclude derivatives) moved from 108% of GDP in 1989 to 395% by 2006 (US$ trillion)

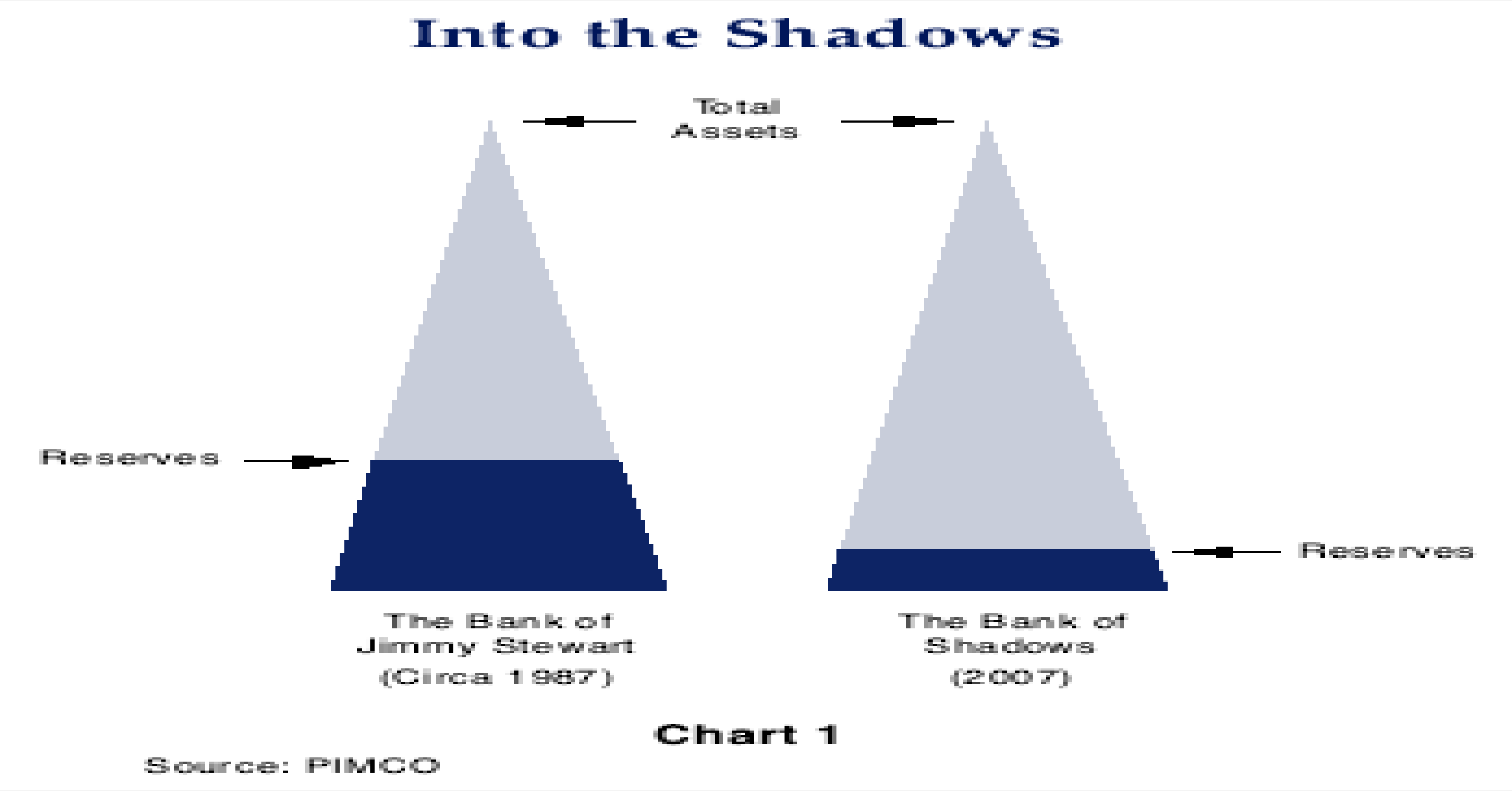
Region	GDP	Reserves (ex.gold)	Stock Mkt Cap	Debt Mkt	Bank Assets	Total Finan. Assets	Total as % of GDP	Fin. Assets % share
World	48.2	5.091	50.8	68.7	70.9	190.4	395.0	100.0
EU	13.6	0.252	13.1	23.2	36.6	72.9	534.4	38.3
North America	14.5	0.090	21.3	28.1	12.1	61.5	424.8	32.3
Japan	4.4	0.880	4.8	8.7	6.4	19.9	456.5	10.4
Other Asia	6.3	1.249	6.9	3.5	7.5	17.9	285.4	9.4
Asia inc Japan	10.7	2.149	11.7	12.2	13.9	37.8	355.7	19.8

(IMF Global Financial Stability Report, Oct. 2007: Table 3)

Global Leverage and Liquidity – the unstable pyramid [source: David Roche,2007]



Bill Gross (PIMCO) – Bank Leverage grew from 1987-2007 by securitizing and moving liabilities off-balance sheet



Regulatory Implications from Subprime

1. How did money centre bank illiquidity occur in a situation of global excess liquidity? Moral hazard
2. How did excess leverage, liquidity, valuation and risk come together for perfect storm? Excessive confidence in static definitions & VaR models
3. Are IFRS fair value accounting and Basel II standards pro-cyclical? Yes
4. Can we reconcile minimum capital adequacy and liquidity requirements for “normal market condition fair value” from compliance requirements for “long tail event” fair value? Possibly Not
5. Operationally, how do regulators detect that markets or borrowers have moved to Ponzi financing? Only through on-site inspection

①Ultimately, capital market reform is about establishing a capital market that is internationally competitive, one which is efficient in mobilising and allocating funds and one which is supported by a strong regulatory framework that imparts confidence to investors

④Emerging Asian capital markets are less hurt by sub-prime directly, but these potential regulatory changes will have an impact readiness of Asian markets to integrate

②Because the international environment is always changing, a main challenge is to have a regulatory framework that is adaptive and flexible

③Recent sub-prime crisis will certainly lead to a major review of existing regulations and consideration of changes involving the role of rating agencies, issue of complex derivatives, liquidity requirements, more stringent rules for asset securitisation and surveillance techniques

Definition for Regional Market Integration in Asia

- In Asia, regional market integration means a process of creating enabling conditions for cross border access whereby:
  - capital can move freely within an economic area
  - issuers are free to raise capital anywhere in the economic area
  - investors can invest anywhere in the economic area

- Regional integration is not intended to exclude non-regional participants but is aimed at building the efficiency, capacity and liquidity needed to compete effectively against global players
- Integration is the process of connecting disparate institutions or organizations through building common codes, rules or regulations that enable people to work together towards common goals

Rationale for Regional Market Integration

✓ Domestic capital market development and reform is a necessary pre-condition for integration into regional and global markets	✓Regional integration can in turn provide the liquidity, scale and capacity to enable individual markets to compete globally and to manage volatility more effectively	✓ Hence, aligning national regulatory approaches will reduce transactions costs and enhance competitiveness

Guiding Principles of Regional Integration

- Regional Integration only works if it proves win-win to all participants
- Hence, transparent process of building consensus towards commonality of purpose key to integration
- This requires acceptance by parties that are hurt by openness and integration and requires process to gain credibility and acceptance by market participants

Seven key principles:

① Value creation and protection of property rights

② Lower transaction costs + better market liquidity

③ Improved corporate governance

④ Better risk management

⑤ Greater financial innovation and range of products

⑥ Access to wider markets and knowledge

⑦ Ownership and fairness

Mutual Recognition vs Harmonization of Standards for Market Integration

Harmonization requires clear uniform standards and strong political will to implement (e.g., EU harmonization to common Financial Directives)

Asian markets are at different stages of development, and timeframe for convergence of standards will vary considerably between countries

However, Asian capital markets run risk of marginalization if they do not co-operate regionally in order to compete globally

Mutual recognition of each other's regulatory regime, recognizing differences and accommodating a variable geometry in the convergence of regulatory standards is the acceptable and pragmatic way forward

Distinguishing between Mutual Recognition and Harmonization

- *Mutual recognition* requires governments to reduce regulatory impediments to free flow of financial services according to a set of internationally accepted standards, recognizing national differences. There is more “flexibility” to achieve convergence in terms of time and commitment

- *Harmonization*, using EU model, requires full acceptance at LEGAL level, of all members and market participants to a single set of rules and services, are treated equally when they operate in the common market

Harmonization with “Single Financial Rulebook”

EU evolution towards full financial integration presents considerable challenges. Experience in EU banking suggests:-

- Co-ordinating national supervisory activities is complex
- Political push by national governments is urgently needed to strengthen cooperation in financial regulation and supervision:
  - a single European rulebook aimed at ensuring equal treatment, low costs of compliance and the removal of regulatory arbitrage
  - an integrated supervision of EU-wide groups, based on complete pooling of information and consolidated supervision of large complex financial groups

Source : FT

2007 ADB Study of Compliance with International Regulatory Standards in ASEAN

Country studies show significant differences in observance of international regulatory and governance standards

Considerable progress in achieving greater market depth, trading volume and openness, further strengthening based on global standards and core principles is needed to help integration and raise competitiveness

National development plans do not always incorporate regional and/or Global integration objectives. Agreement that the key objective of regional integration is to build capacity and scale to be able to compete globally. Key constraints are existing capital restrictions and lack of harmonization of market practices and regulatory standards

Compliance with IOSCO Objectives and Principles

Singapore FSAP Assessment (2002-2003) - most principles fully and broadly implemented. Recommendation - further strengthen valuation methods and disclosure practices of CIS
Malaysia Self Assessment (2006) - most principles fully and broadly implemented. Recommendation - further align Malaysian Accounting Standards with international standards
Thailand Assisted Self Assessment (2004) in preparation for FSAP - most principles fully and broadly implemented. Recommendation - strengthening of legal provisions & procedural arrangements for information sharing, investigation powers, appointment of administrators to take control over market intermediaries when warranted and access to collateral and clearing funds of clearing house in event of member default

Compliance with IOSCO Objectives and Principles

Philippines FSAP Assessment (2002) and assisted self-assessment - majority of principles fully or broadly implemented; several principles only partially implemented. Recommendation - strengthening of laws, regulations and practices in the regulation of investment advisors, full implementation of exchange governance arrangements, segregation of client assets, standards for CIS disclosures, oversight of SROs and regulators' access to market surveillance system
Indonesia Assisted Self Assessment (2005) - several principles are only partially implemented. Recommendation - transparency of regulators' approach, independence of regulator, information sharing/co-operation arrangements; procedures to deal with failures of intermediaries, supervision and governance of CISs

IOSCO Multilateral Memorandum of Understanding (international standard)

- Within ASEAN, MAS and Securities Commission, Malaysia are among global 44 signatories of the IOSCO MMoU
- BAPEPAM Indonesia, SEC Philippines and SEC Thailand are among 16 members listed in the IOSCO MOU Annex B (committed to signing)
- IOSCO members accepted as signatories of the MMoU have the rights and powers under national law to engage in consultation, co-operation and exchange of information with other jurisdictions on matters concerning co-operation in securities market regulation, as well as the prevention and investigation of securities market abuse

  Signatories are further encouraged to upgrade national regulations to IOSCO standards, thus facilitating the mutual recognition process

Elements of a Regional Integration Strategy

① Recognize in domestic capital market development plans explicit to regional integration goals
② Establish coordinating mechanism for public-private consultation for financial and monetary integration process (Wise Men Group)
③ Sequence the liberalization of capital account and portfolio restrictions
④ Implement a mutual recognition framework while continuing to strengthen and harmonize legal and regulatory framework in line with global standards
⑤ Adopt MMOU and other standards as basis for Mutual Recognition and implement with technical assistance either bilaterally or from ADB and other IFI sources
⑥ Considerable opportunities to strengthen regional co-operation in capital market products (equity, bonds, fund management and derivatives) including exchange co-operation

Implementing a Mutual Recognition Regime

Mutual Recognition is easiest on Bilateral basis, with structured process of variable geometry - bilateral technical assistance [+ e.g., ADB TA] can remove key barriers and identify quick wins			
➢ Use MMOU and FSAP standards	➢ Focus on Mutual recognition of specific products, e.g., mutual funds, will draw attention to need for liberalization of exchange controls and portfolio restrictions	➢ Market infrastructure could be easily upgraded to a level conducive to integration via "interoperability and interconnectivity" according to CPSS and G-30 standards	➢ Once bilateral conditions achieved, multilateral mutual recognition becomes easier

Domestic Issues for Mutual Recognition Regime

① Strengthen legal and regulatory framework to international standards

② Identify and define priority areas where mutual recognition can enhance market development (e.g., IPOs, cross-border trading of products)

③ Identify and implement legal and regulatory actions needed to implement mutual recognition

④ Set up a regional system of expert-assisted self-assessments (and independent assessments) of regulatory and governance standards and the transparency of such assessments

⑤ Encourage, including through mutual recognition, regionally active market intermediaries, which can provide connectivity through distribution and investment promotion services, across the region

Concluding Remarks

- In sum, mutual recognition - initially on bilateral basis and ideally, progressing to a multilateral basis - is pre-condition to regional integration
- Aim is to strengthen domestic competitiveness, hence raising domestic standards on focused and step-by-step basis is right way to go
- Mutual recognition and use of bilateral and IFI assistance is catalytical to changes that are necessary to bring domestic stakeholders to focus on need for reforms
- Much depends on self-assessment of weaknesses and priority areas of reform. FSAP process will help identify priorities

Questions & Answers

Thank You

as@andrewsheng.net